

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Davis Analyst: Jeani Brent Bill Number: AB 1752  
Related Bills: SB 2189 (1998) Telephone: 845-3410 Amended Date: 06/25/98  
Attorney: Doug Bramhall Sponsor: \_\_\_\_\_

**SUBJECT:** California Seed Capital and Early Stage Corporation Fund Investment Credit

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

☒ AMENDMENTS IMPACT REVENUE. A revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended \_\_\_\_\_.

☒ FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED \_\_\_\_\_ STILL APPLIES.

☒ OTHER - See comments below.

### SUMMARY OF BILL

Under the Corporations Code, this bill would establish the California Seed Capital and Early Stage Corporation (the corporation), to mobilize investment in private seed and venture capital partnerships or entities through a single designated for-profit investment fund.

Under the Revenue and Taxation Code, this bill would allow taxpayers to claim credits against their insurer gross premium, personal income, or bank and corporation tax, as certified by the corporation, for any shortfalls that occur in the scheduled returns to investors of invested capital and returns on invested capital.

The Revenue and Taxation Code provisions relating to the insurer gross premium tax credit is not discussed in this analysis because that tax is not administered by the Franchise Tax Board. The Corporations Code provisions relating to the creation of the corporation are discussed only to the extent they apply to the income tax credits.

### SUMMARY OF AMENDMENT

The June 25, 1998, amendments made various changes to the Corporations Code provisions and added the provisions relating to the allowance of tax credits.

### EFFECTIVE DATE

This bill would become effective January 1, 1999, and the bill specifies that no credit may be claimed before January 1, 1999, nor after December 31, 2025.

### Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

### Department Director

### Date

Gerald H. Goldberg

8/3/98

#### PROGRAM HISTORY/BACKGROUND<sup>1</sup>

"During the last two decades, several states have created state-sponsored venture capital programs to provide financing for new and small business. Venture capital programs are public sector activities that mimic or work with venture capitalists to provide capital for companies in a development state."

"All of these state programs involve at least an initial contribution of money by the state for business capital investment purposes. The programs can then be divided into two main categories:

- "Public-private funds are principally privately managed. The state contributes initial capital, although it is usually matched by private investments and sometimes by pension fund investments. The state often sets some criteria for selecting companies in which investments will be made. . . . "
- "Publicly run venture capital programs have a larger public role in their management. . . . "

"Funds to establish these programs have come from several sources. Most states directly appropriated some initial capital. A few states were able to supplement that with federal grants. Most programs are revolving funds, and are allowed to reuse repayments of investments made. Connecticut's program began with \$10 million in general obligation bond proceeds. . . . Oregon's program uses lottery proceeds. Michigan used a state loan from oil and gas royalties, and more recently gaming revenues. Oklahoma found a remarkably innovative way to use tax credits to fund its programs. The legislature gave the program \$50 million in tax credits. The program uses those tax credits to guarantee loans made at its direction by institutional investors (banks, mostly). If a loan fails, the program sells tax credits sufficient to make good on the institutional investor's loan. So far, Oklahoma has used this device to raise over \$20 million, and has not had to sell any tax credits."

#### SPECIFIC FINDINGS

**Existing state and federal laws** provide various tax credits that are designed to provide tax relief for taxpayers who must incur certain expenses (e.g., child and dependent care credits) or to influence behavior, including business practices and decisions (e.g., research credits).

**Under existing state and federal laws**, generally tax credits may be claimed only by the taxpayer that incurred the credit-related expense. In the case of the low-income housing credit, if a property is acquired during the credit period, the credit may be transferred to the acquiring taxpayer. In addition, the low-income housing credit may be transferred between wholly-owned affiliated corporations.

**The California Constitution** provides that the power to tax may not be surrendered or suspended by grant or contract.

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<sup>1</sup> Information in this section is from Business Capital Needs in California: Designing a Program, by Gus Koehler, Ph.D. and Rosa Maria Moller, Ph.D., a report developed by the California Research Bureau, California State Library, April 1998.

**AB 1752** would allow taxpayers to claim credits against their personal income or bank and corporation tax, as certified by the corporation, for any shortfalls that occur in the scheduled returns to investors in the California Seed Capital and Early Stage Corporation Fund of invested capital and returns on invested capital. The bill provides that the credits could be freely transferable to subsequent transferees. The bill states that the corporation shall certify the amount of tax credits that are to be allowed to investors and the years those tax credits may first be claimed. The credits are to be sufficient to support the raising of \$500 million of investment capital.

Further, **this bill** provides that, in conjunction with the Franchise Tax Board, the corporation shall develop a system for registration of any tax credits allowed or transferred and a system that permits verification that any tax credit claimed on a tax return is valid and properly taken in the year in which it is claimed, and that any transfers of credits are made in accordance with the bill.

#### Policy Considerations

Generally, tax credits are allowed to the taxpayer who incurred the related expense. Under state law, only the low-income housing credit contains a transfer provision, which allows transfer of the credit to the purchaser of the property or between affiliated corporations. Federal tax law allows no transfer of tax credits. Conversely, this bill would allow the credit to be transferred and does not restrict the class of eligible transferees and, thus, would create a precedent by allowing the credit to be transferred from the taxpayer who invested in the California Seed Capital and Early Stage Corporation Fund to any other taxpayer. Further, the bill would not limit the number of times a credit may be transferred and does not address whether only the entire credit or portions of the credit may be transferred. If portions of the credit may be transferred, the bill does not address whether or how one credit may be divided among multiple transferees. As discussed with the author's staff, the attached amendments would amend the Revenue and Taxation Code provisions to limit the transfer of this credit to affiliated corporations similar to the provisions contained in the low-income housing credit, but would require the standard 50% ownership criterion instead of the 100% ownership criterion contained in the low-income housing credit. Also, the amendments would modify the Corporations Code provision to refer to the transfer rules contained in the Revenue and Taxation Code.

Credits generally are enacted with parameters on the amount of credit allowed to each taxpayer and/or on the aggregate total amount of tax credits that may be allocated. While private corporations may be delegated the authority to allocate the credits, this allocation may not exceed the amounts provided in the law. This credit, however, would set no parameters and instead would allow the amount of credit for each taxpayer and the total amount of credit for all taxpayers to be determined solely by the contract between the corporation and the investors. Providing the corporation the power ultimately to determine the parameters of the tax credit provided in this bill might be considered an unconstitutional surrender of the power to tax.

### Implementation Considerations

For the department to properly administer this bill, the Corporations Code language regarding the period during which the credits are allowed, certification and transfer of the credit, and notification to the Franchise Tax Board also should be reflected in the Revenue and Taxation Code provisions. In accordance with discussions with the author's staff, the attached amendments would provide standardized language to reflect these provisions in the Personal Income Tax and Bank and Corporation Tax Law sections. The attached amendments specify requirements for the corporation to report to the department information regarding the certification of credits. Further, the attached amendments would remove the Corporations Code provision that would require the corporation, in conjunction with the Franchise Tax Board, to develop a system for registration of any tax credits, since this provision effectively would be replaced with the certification provisions included in the attached amendments.

### FISCAL IMPACT

#### Departmental Costs

If the bill is amended to resolve the implementation consideration addressed in this analysis, the department's costs are expected to be minor.

#### Tax Revenue Estimate

The revenue impact of this bill would depend on the amount invested in the fund, the scheduled return less the realized return (assuming the realized return is less than the scheduled return), the tax liability of investors and transferees, and the propensity of these credits to be transferred among taxpayers. It is not known how the fund might fare nor is it known what the scheduled return might be. Although the revenue impact cannot be estimated, the risk of loss is significant. For example, if the fund were to accumulate the \$500 million target amount at a scheduled return of 10%, but only realize a return of 5%, the shortage would be \$25 million (\$50 million scheduled return v. \$25 million realized.) Generally, the potential revenue impact of a tax credit is estimated in part by considering a usage rate each year of less than 100% of the credits earned because some taxpayers who earn a credit will not have sufficient tax liability to use the full amount of the credit in the year it was earned. Because the credit provided by this bill may be freely transferred from those taxpayers without sufficient tax liability to those with sufficient tax liability, this bill potentially could result in 100% usage of credits in the year they are earned.

### BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 1752  
As Amended June 25, 1998

AMENDMENT 1

On page 7, strikeout lines 9 and 10, and insert:

this chapter. The tax credit allowed may be assigned to affiliated corporations pursuant to subdivision (e) of Section 23626 of the Revenue and Taxation Code; however, no tax

AMENDMENT 2

On page 7, strikeout lines 34 through 39 and on page 8, strikeout lines 1 through 2.

AMENDMENT 3

On page 9, modify lines 5 through 18, as follows:

17059. ~~There~~ (a) For each taxable year beginning on or after January 1, 1999, and before January 1, 2026, there shall be allowed as a credit against the "net tax" (as defined by Section 17039) a credit in an amount prescribed in a certificate issued by the California Seed Capital and Early Stage Corporation pursuant to Chapter 3 (commencing with Section 14100) of Part 5 of Division 3 of Title 1 of the Corporations Code.

(b) The California Seed Capital and Early Stage Corporation shall do all of the following:

(1) Certify the amount of tax credit allowed to each taxpayer pursuant to Section 14114 of the Corporations Code and the taxable year the credit may first be claimed by the taxpayer.

(2) Obtain the taxpayer's taxpayer identification number, or each partner's taxpayer identification number in the case of a partnership, for tax administration purposes.

(3) Provide an annual listing to the Franchise Tax Board, in the form and manner agreed upon by the Franchise Tax Board and the California Seed Capital and Early Stage Corporation, containing the names, taxpayer identification numbers pursuant to paragraph (2), and total amount of credit certified to each taxpayer.

(c) The taxpayer shall do all of the following:

(1) Retain a copy of the certification issued by the California Seed Capital and Early Stage Corporation as specified in paragraph (1) of subdivision (b).

(2) Provide the certification specified in paragraph (1) of subdivision (b) to the Franchise Tax Board upon request.

(3) Provide the California Seed Capital and Early Stage Corporation with the taxpayer's identification number, or in the case of a partnership, the taxpayer identification numbers of all partners.

(d) For purposes of this section only, "taxpayer" means an investor, as defined by subdivision (f) of Section 14101 of the Corporations Code.

(e) This section shall remain in effect only until December 1, 2026, and as of that date is repealed.

SEC. 4. Section 23626 is added to the Revenue and Taxation Code, to read:  
23626. ~~There~~ (a) For each income year beginning on or after January 1, 1999, and before January 1, 2026, there shall be allowed as a credit against the "tax" (as defined by Section 23036) a credit in an amount prescribed in a certificate issued by the California Seed Capital and Early Stage Corporation pursuant to Chapter 3 (commencing with Section 14100) of Part 5 of Division 3 of Title 1 of the Corporations Code.

(b) The California Seed Capital and Early Stage Corporation shall do all of the following:

(1) Certify the amount of tax credit allowed to each taxpayer pursuant to Section 14114 of the Corporations Code and the income year the credit may first be claimed by the taxpayer.

(2) Obtain the taxpayer's taxpayer identification number, or each shareholder's taxpayer identification number in the case of a subchapter S corporation, for tax administration purposes.

(3) Provide an annual listing to the Franchise Tax Board, in the form and manner agreed upon by the Franchise Tax Board and the California Seed Capital and Early Stage Corporation, containing the names, taxpayer identification numbers pursuant to paragraph (2), and total amount of credit certified to each taxpayer.

(c) The taxpayer shall do all of the following:

(1) Retain a copy of the certification issued by the California Seed Capital and Early Stage Corporation as specified in paragraph (1) of subdivision (b).

(2) Provide the certification specified in paragraph (1) of subdivision (b) to the Franchise Tax Board upon request.

(3) Provide the California Seed Capital and Early Stage Corporation with the taxpayer's identification number, or in the case of a subchapter S corporation, the taxpayer identification numbers of all shareholders.

(d) For purposes of this section only, "taxpayer" means an investor, as defined by subdivision (f) of Section 14101 of the Corporations Code.

(e) (1) A corporation may elect to assign any portion of any credit allowed under this section to one or more affiliated corporations for each income year in which the credit is allowed. For purposes of this subdivision, "affiliated corporation" means a corporation that is a member of a commonly controlled group as defined in Section 25105, as of the last day of the income year in which the credit is allowed.

(2) The election provided in paragraph (1):

(A) May be based on any method selected by the corporation that originally receives the credit.

(B) Shall be irrevocable for the income year the credit is allowed, once made.

(C) May be changed for any subsequent income year if the election to make the assignment is expressly shown on each of the returns of the affiliated corporations that assign and receive the credits.

(f) This section shall remain in effect only until December 1, 2026, and as of that date is repealed.